Appendix B: Income taxation and economic growth

Economists agree unanimously that higher tax rates have a negative effect on economic growth.

Romer and Romer (2010)\textsuperscript{i} find that exogenous tax increases have a negative effect on real GDP. The maximum effect of a tax increase equivalent to 1 percent of GDP is a fall in output by almost 3 percent after 10 quarters. Tax increases have a very large and sustained negative effect on output.

To understand why output declines, Romer and Romer (2010)\textsuperscript{ii} find that a tax increase (tax on labor and capital) of 1 percent of GDP leads to a 2.55 percent fall in personal consumption expenditures, a 11.19 percent fall in gross private investment. Exports rise substantially and imports fall. The rise in net exports is consistent with the tax increase lowering interest rates and hence reducing capital inflows.

These results are also consistent with the findings of Blanchard and Perotti (2002)\textsuperscript{iii} and Mountford and Uhlig (2009).\textsuperscript{iv} Investment falls in response to both tax increases and government spending increases. Consumption does not rise significantly in response to a fiscal policy change. Government spending increases have a negative effect on the real wage of workers.

In addition, the economics literature shows that tax policies which penalize investment are more harmful to productive economic activity than taxes on consumption (see, Arnold et al., 2011\textsuperscript{v}; Gemmell et al, 2011\textsuperscript{vi}; Romer and Romer, 2010\textsuperscript{vii}; Blanchard and Perotti, 2002\textsuperscript{viii}; Padovano and Galli, 2001\textsuperscript{ix}; Bleaney et al., 2001\textsuperscript{x}; Mullen and Williams, 1994\textsuperscript{xi}).


\textsuperscript{ii} Ibid.


